

**FINANCIAL INSTITUTIONS COMMITTEE MEETING**  
**Business Law Section, State Bar of California**

Meeting of September 12, 2006

**Committee Members Present:** John Hancock, Chair; Rosie Oda, Secretary; Michael Abraham; Leland Chan; Laura Dorman; Andrew Druch; Bart Dzivi; Andy Erskine; Rob Hale; Linda Iannone; Elaine Lindenmayer; Teryl Murabayashi; Allan Ono; Mary Price; Brad Seiling; Will Stern; Bob Stumpf; Keith Ungles; and Richard Zahm.

**Advisory Members and Others Present:** Paul Bond; Sally Brown; Gino Chilleri; Ivan Cintron; Clay Coon; Ted Kitada; Bob Mulford; Michael Occhiolini; Isabelle Ord; Mike Ouimette; Thomas Quinlan; Jim Rockett; Neil Rubenstein; Gerry Tsai; and Maureen Young.

**Committee Members Absent:** Bruce Belton; Jim Dyer; Mark Gillett; Jay Gould; Randy Kennon; Rosemary Lemmis; Todd Okun; Russ Schrader; Meg Troughton, Vice Chair; Mike Zandpour.

**Call to Order:** Our Chair John Hancock of World Savings called the meeting to order at 9:35 a.m.

**Welcome to Members and Advisory Members:** John welcomed the Committee Members and the Advisory Members and asked each person to identify themselves and where they worked.

**1. Approval of August 8, 2006 Minutes:** The Committee approved the minutes of the August 8, 2006 meeting.

**2. Report on the FIC presentation on Credit Union Conversions:** Our Chair John reported that our seminar on Credit Union Conversions which was held at the Federal Reserve Bank of San Francisco on September 8, 2006, and featured Professor Jim Wilcox of the Haas School of Business, went very well. Rosie Oda of Pillsbury, who organized the event, thanked Assistant General Counsel Gerry Tsai of the FRB-SF for arranging the venue. Leland Chan of the California Bankers Association (“CBA”) arranged for Barrie Graham, a Director of the CBA to be on the panel, and Ron Fong of the California Credit Union League briefly explained the differences between banks and credit unions. About 50 people attended, many of whom traveled to California from other states, and the audience included 8 credit unions. We also had a special guest from Washington, D.C., John Bowman, Chief Counsel, Office of Thrift Supervision, on the panel as well as Harold Hanley, an investment banker from Keefe Bruyette & Woods. Rosie has .pdf versions of all of the handouts if anyone would like a copy emailed to them.

**3. Data Security Litigation:** Meg Troughton of BofA arranged a special presentation by Thomas Quinlan and Paul Bond of Reed Smith updating the Committee on the latest litigation concerning data security breaches, for which a powerpoint had previously been

distributed. Tom indicated that he now often hears that data security could fill the gap caused by the curtailment of class action securities litigation in terms of providing revenue to the plaintiffs bar. Currently, the government is the primary source for enforcement of state laws (34 different states have enacted laws in this area). There are many differences between these state laws, which can even cover loss or theft of paper records. These laws address people's concerns about identity theft even where no actual loss may have occurred. There is no uniform standard of care, which almost depends on who is regulating the entity. After sending out notices of data security breaches, companies have been receiving notices of class actions almost by return mail since the recipients appear to define a natural class. Free limited credit monitoring, commonly offered as a courtesy to apprehensive customers, has been pled as an admission of negligence. The FTC has proposed regulations implementing FACTA that would include utilities, telecoms and auto dealers as "financial institutions" subject to the requirements. To minimize class action potential, Paul recommended that individual notices be provided instead of a website announcement.

The biggest money to change hands has involved government enforcement. Because of the small likelihood of actual loss, courts have not been awarding jackpot payoffs. A court in New Jersey has even found no standing where there was no loss. Tom summarized his advice as:

- 1) Don't over-promise on security;
- 2) Encrypt as much as possible;
- 3) Police off-site locations;
- 4) Ask whether this person needs this information;
- 5) Get senior management and employee buy-in;
- 6) Audit compliance.

Sally Brown of BofA asked whether plaintiffs have had much success with breach of fiduciary duty claims, and Paul replied that none have gone very far. Plaintiffs have not quite been able to articulate a sound basis for a money award yet.

**4. *Interior Crafts, Inc. v. Leparski*:** Bob Mulford of the FRB-SF reported on this recent Illinois case involving payment over a forged endorsement under the UCC. An employee of Interior was depositing checks received by Interior into his own personal account at Marquette using an ATM machine owned by Pan American Bank. Under Reg CC, the account holding bank (Marquette) was the bank of deposit but under Illinois law, it was Pan American. The court applied the Illinois law and held Pan American liable as the depository bank even though it had no way of knowing who was the account holder. The checks never got to Marquette. Bob pointed out that there is no recourse for the ATM owner unless it is provided for contractually.

**5. OCC Bulletin on Gift Cards No. 2006-34 (Aug. 14, 2006):** Ted Kitada of Wells reported that this Bulletin was issued in response to the many state laws on gift card disclosures. It requires disclosure of the expiration date, the amount or existence of any monthly maintenance and dormancy fees, and how consumers may obtain additional information about their cards. Ted pointed out that it is silent on the effective date of this bulletin, so banks may face an issue with respect to its impact on existing card stock.

**6. Private Money Lenders** – Richard Zahm, founder of Second Angel Bancorp, in response to a recent article in the American Banker, “Banks and Regulators Clash over Surge in Real Estate Loans” which neglected to mention his industry, explained his company and his industry to us. He described private money lending as “asset based lending collateralized by real estate.” His company is pioneering a new financial services industry along with a couple of other competitors: Redwood Financial and California Mortgage & Realty. Richard describes Second Angel as a licensed finance lender that acts as a mortgage bank. It raises funds by issuing interests in \$50 million closed-end money funds collateralized by commercial mortgages, relying upon the intrastate exemption from the Securities Act of 1933. These securities are not limited to accredited or sophisticated investors but are sold to retirees and other California investors with \$65,000 in income and \$250,000 in assets, or net worth of \$500,000, with 500 investors per fund. Richard explained that he can also accept funds from international investors without qualification. His company does not rely on traditional credit analysis, placing more emphasis on valuation methods such as on-site inspections. His company offers speed and flexibility for 2-3 points over the institutional lender range. Opportunity costs make it worth it to a borrower to pay the higher rates. Second Angel is regulated by the Department of Corporations, the Department of Real Estate, and the Department of Industrial Relations (because it issues 401k funds).

**7. Fed Rule on Payroll Cards:** Ted Kitada reported that while this issuance defines the term “payroll cards,” it does little to clarify whether commissions are included, though it does exclude incentive based payments. The rule was effective on July 1, 2006, and offers a way to address the periodic statement requirement. The issuer must have balance information available by phone, and if a consumer asks, the statement must be provided by hard copy. The Fed did not cross reference the E-Sign option of providing a hard copy, instead choosing to require it upon request. It is a significant step in reducing costs of offering this product.

**8. Interim Final Rule on Reg E:** Ted reported that this rule will be effective on January 1, 2007. It provides for assessment of fees when a check or ACH debit entry is returned. A new Model Clause No. A-8 is provided with respect to assessment of returned check fees. This language must also appear in notices posted at the point of sale, etc. Ted urges committee members to comment because the clause is longer than will fit on the notice.

**9. Wachovia Bank, N.A. v. Foster Bancshares, Inc.:** Ted reported on this Seventh Circuit case, which he previously provided, which was decided in July and concerns check truncation. In this case the paying bank truncated the check, which was followed by a dispute over whether the check was counterfeit or altered. The customer had substituted her name as payee for the name of the company originally designated, using copying technology, and deposited it at Wachovia. After withdrawing the funds from her account at Foster Bank, she then vanished. The company sued Wachovia for the amount of the check. Ted pointed out that if the entire check were counterfeit or forged, it would be the paying bank’s liability. If it were simply altered as to payee, it would be the

depository bank's liability. If one can't tell whether it's counterfeit or altered, it's the liability of the depository bank.

Bob Mulford points out that the 7<sup>th</sup> Circuit held that if it is impossible to determine whether an altered payee name was due to simple replacement of the original payee's name on the original check, or whether the original check was replaced with a complete counterfeit, one should presume that it was the more traditional fraud (simple replacement of the payee's name), so the liability would be the depository bank's, for breach of its warranty of nonalteration. However, the court was apparently unaware of the most recent Federal legislation in the check area – the Check Collection for the 21<sup>st</sup> Century Act ("Check 21"). In that statute, Congress said that the bank that wants to take advantage of new check technology should bear any risks created by the technology. In the Wachovia case, it was the payor bank (Wachovia) that replaced the original check with an image. Applying the rationale of Check 21, Wachovia should have taken the loss. Accordingly, it is possible that another court, guided by more knowledgeable lawyers, might reach a different result.

**10. FDIC Inquiry Re: Industrial Loan Company ("ILC") Charters (Aug. 17, 2006):**

Maureen Young of Bingham McCutcheon reported on the FDIC's solicitation of comments on issues relating to ILCs. This is all related to Wal-Mart's application for an ILC charter, and the FDIC's previous imposition of a six month moratorium on action to accept, approve or deny ILC charter applications. Maureen noted that the FDIC has identified 12 issues to discuss, including whether ILCs pose differing risks depending on whether their owners are commercial or financial entities, and also whether or not to close the ILC "loophole" under the Bank Holding Company Act. Maureen speculated that this inquiry is really just a way to pass the time to let the Wal-Mart controversy dissipate.

**11. FDIC Guidance on OffShore Outsourcing, FIL-52-2006 (June 21, 2006):**

Maureen Young also reported on this FDIC guidance, which she informed us does not change anything provided as guidance in the past, including the 2000 Federal Reserve regulation and the 2002 OCC letters. She noted that a lot of legislation has been proposed to curtail outsourcing abroad. She also noted that some foreign contractors, located for example in India, have been subcontracting with companies located in other, even cheaper, countries, such as China. She warned bankers to assure that disaster recovery is provided for outside the country where the work has been outsourced, preferably in the U.S. She also cautioned bankers to provide access to the outsourced work to their regulators.

**12. Federal Legislative Report:** Bart Dzivi reported that no official action has taken place, and that the federal legislative process had only 9 remaining days. He has heard that the staffs of the Senate and House are working on a Regulatory Relief compromise, which still has a chance to pass. The legislation could also get kicked into a lame duck session. Jim Rockett of Bingham McCutcheon asked whether the director liability provision would be included in the compromise, and Bart responded that this is likely,

but he hasn't actually seen the draft compromise bill. Jim noted that this provision would be very onerous for banks seeking to fill director positions.

**13. State Legislative Report:** Bob Mulford reported that the State Legislature was done for the year. The only remaining question is how much that has already passed will be vetoed by the Governor. He noted that AB 1965, on debt deferral for soldiers in the reserve did not make it through.

**14. New Members:** John asked that we vote on three new members: Andy Erskine, the Executive Vice President and Deputy General Counsel of Countrywide, and Will Stern, a litigation partner at Morrison, and Joe Sanchez of Bank of the West. Will left the room and Andy hung up so we could vote, and all three were unanimously accepted for the coming year. John reported that we have one slot that will open in November and that he asked that outgoing members inform him whether they will continue as advisory members.

**15. *Frazier Nuts, Inc. v. American Ag. Credit*:** Bob Stumpf updated us on this case, which he described at our last meeting, reporting that he has filed a petition for review by the Supreme Court. He has received amicus support from Wells and the CBA. John indicated that he will be following this case in his new role as General Counsel for Rabobank's California bank subsidiary located in Roseville.

**16. Adjournment:** The meeting was adjourned at 11:30 a.m.